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US – Lead and Bismuth II
United States – Imposition of Countervailing Duties on Certain Hot-Rolled Lead and Bismuth Carbon Steel Products Originating in the United Kingdom: Here Today, Gone Tomorrow? Privatization and the Injury Caused by Non-Recurring Subsidies*

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1 Facts of the case

In 1993, the US Department of Commerce began to levy countervailing duties on imports of certain leaded bars from the United Kingdom. The United States applied tariffs to goods imported from British Steel Engineering Steels, a subsidiary of British Steel plc. Following investigations by the US Department of Commerce and the United States International Trade Commission, the US authorities held that the imposition of duties was both required by Section 701 of the Tariff Act of 1930 (as amended) and not in violation of any of the country's obligations as a member of the World Trade Organization.

In its investigation of the domestic industry's petition for countervailing duties, the US Department of Commerce determined that British Steel Engineering Steels was the owner of assets that originally belonged to British Steel Corporation, a former state-owned company in the United Kingdom. According to the US Department of Commerce, British Steel Corporation received equity infusions and outright grants from the British government totaling £7 billion between 1977 and 1986 that were used to develop capacity for producing leaded bars.

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In 1986, British Steel Corporation joined with the privately owned Guest, Keen, and Nettlefolds to create a joint venture known as United Engineering Steels Limited. Both British Steel Corporation and Guest, Keen, and Nettlefolds contributed assets to United Engineering Steels Ltd., including the assets for producing leaded bars that were formerly held by British Steel Corporation. In 1988, the British government privatized British Steel Corporation by first ceding all of its property, rights, and liabilities to British Steel plc and then selling its shares in that company on the equity market. The US Department of Commerce did not dispute the British government's claim that its sales of British Steel plc shares took place at arm's length and for fair market prices. Still, it ruled that the benefits that British Steel Corporation had garnered from the equity infusions and cash grants had "traveled" to its successor company, British Steel Engineering Steels.

Under US trade law, an equity infusion by a government on terms different from those that would be required by a private investor is considered to be a *non-recurring subsidy*. When such a subsidy causes or threatens to cause material injury to a domestic industry, the law allows for the imposition of a countervailing duty. Since the US Department of Commerce ruled that the subsidy that had been granted to British Steel Corporation had "passed through" to British Steel Engineering Steels upon the change in asset ownership, it deemed a countervailing duty on imports from British Steel Engineering Steels to be appropriate. The US Department of Commerce computed the size of the tariff by first allocating a portion of the grants made to British Steel Corporation to the production of leaded bars and then assessing the useful life and depreciation pattern of the assets that were purchased by British Steel Corporation with the funds contributed by the British government.

2 Issues raised before the WTO Panel

The European Communities complained to the panel that the United States had failed to act in conformity with its obligations under the WTO Agreement on Subsidies and Countervailing Measures (hereinafter, the SCM Agreement) when it imposed countervailing duties on imports of leaded bars from the United Kingdom following administrative reviews in 1995, 1996, and 1997. The European Communities did not dispute the legality of the countervailing duties originally imposed by the United States on imports of leaded bars, although it could have done so on grounds similar to those elaborated in its complaint.

The dispute between the United States and the European Communities arose because the latter – which were legally entitled to represent British Steel plc/British Steel Engineering Steels before the WTO – disagreed with the US Department of Commerce determination that a benefit from a non-recurring subsidy had passed through to British Steel Engineering Steels upon the change in ownership of the capital used to produce leaded bars. In the judgment of the European Communities, the current owners of British Steel Engineering Steels could not have "benefited" from any subsidy to British Steel Corporation, because the British government sold its holdings in British Steel plc at fair market prices.

The European Communities argued that the US actions were inconsistent with a series of provisions of the SCM Agreement, most notably Article 21, Article 19 (which, in the opinion of the European Communities, provides the context for Article 21), Article 10, Article 1, Article 2, as well as Article VI.3 of the GATT. Article 21 of the *SCM Agreement* governs the duration and review of countervailing duties.

The WTO Members agree that a countervailing duty shall remain in force only for as long as is necessary to counteract the effects of a subsidy that causes material injury to an industry in the importing country. In Article 21.1 (which is of particular relevance to the dispute at hand), the WTO Members agree that

> if as a result of the review under this paragraph, the authorities determine that the countervailing duty is no longer warranted, it shall be terminated immediately.

Article 19.1 of the SCM Agreement dictates that countervailing duties must be levied in accordance with the provisions of the SCM Agreement and Article 19.4 further stipulates that no countervailing duty

> shall be levied on any imported product in excess of the amount of the subsidy found to exist.

Article 10, echoing Article 19.1, makes it clear that the imposition of countervailing duties shall only occur in accordance with the relevant provisions of the SCM Agreement and in its footnote 36 clarifies that the purpose of a countervailing duty is to offset a subsidy, as provided in Article VI.3 GATT.

Finally, Articles 1 and 2 of the SCM Agreement provide the agreed definition of a subsidy. According to Article 1.1 and Article 2.1, a subsidy can be deemed to exist only if a government makes a payment that confers a benefit to a specific enterprise or industry (or group of enterprises or industries). The European Communities argued that neither British Steel plc/British Steel Engineering Steels nor any other enterprise or industry in existence at the time of the administrative reviews undertaken by the US Department of Commerce could have benefited from any subsidy that might have been paid in the past, because a fair market price had been paid for all assets used to produced leaded bars. According to the European Communities, the United States should not have continued its countervailing duties upon administrative review, because one of the preconditions for a countervailing duty – namely, the existence of a subsidy that confers a benefit – was not satisfied.[1]

In the hearings before the Panel, the United States did not dispute the EC allegation that the assets of British Steel plc once held by the British government had been sold at a fair market price. Rather, the United States maintained that, even if this indeed was the case, the benefit of the original subsidy had passed through to the acquiring entity and thus the goods produced with the subsidized capital could be lawfully subject to countervailing duties.

3 Decision of the Panel

In its report, *United States – Imposition of Countervailing Duties on Certain Hot-Rolled Lead and Bismuth Carbon Steel Products Originating in the United Kingdom* (WT/DS138/R), the Panel sided with the European Communities, concluding that

> . . . by imposing countervailing duties on 1994, 1995 and 1996 imports of leaded bars produced by UES and BSplc/BSES respectively, the United States violated Article 10 of the SCM Agreement.
>
> (Panel Report, para. 7.1)

The Panel reached this conclusion because, in its view,

> . . . the USDOC should have examined the continued existence of "benefit" already deemed to have been conferred by the pre-1985/86 "financial contributions" to BSC, and it should have done so from the perspective of UES and BSplc/BSES respectively, and not BSC.
>
> (Panel Report, para. 6.70)

[1] The European Communities did not request a retroactive remedy (that is, reimbursement of duties perceived to be illegal) in case the Panel would agree with its argument. Since the Panel was not confronted with such a request, it was required, in accordance with the maxim *non ultra petita*, to confine its findings to the issue invoked by the European Communities.

Moreover, the Panel noted that

> . . . fair market value was paid for all productive assets, goodwill etc. employed by UES and BSplc/BSES in the production of leaded bars imported in the United States in 1994, 1995 and 1996. In these circumstances, we fail to see how pre-1985/86 "financial contributions" bestowed on BSC could subsequently be considered to confer a "benefit" on UES and BSplc/BSES during the relevant periods of review.
>
> (Panel Report, para. 6.81)

This reasoning led the Panel to conclude that the countervailing duties imposed by the United States on leaded bars were illegal under the WTO Agreement.

4 The US appeal and the Appellate Body's decision

The United States raised two issues in its appeal to the Appellate Body (AB).[2] First, the United States argued that the Panel did not apply the correct standard of review when evaluating the lawfulness of the US Department of Commerce actions: the Panel applied the review standards outlined in Article 11 of the Understanding on Rules and Procedures Governing the Settlement of Disputes (the DSU) whereas, in the view of the United States, the appropriate standard was that outlined in Article 17.6 of the Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994 (the Anti-dumping Agreement).

Second, the United States argued that the panel had erred in ruling that the US Department of Commerce should have focused its administrative review on whether a benefit had accrued to the owners of British Steel plc/British Steel Engineering Steels following the privatization of British Steel Corporation. Rather, the United States argued, it was enough for the US Department of Commerce to consider whether a subsidy had conferred a benefit to industry production. The United States felt that the Panel further erred in finding that United Engineering Steel Ltd. and British Steel plc/British Steel Engineering Steels had gained no benefit from the British government's financial contributions to British Steel Corporation.

The AB rejected both of the US claims. The AB ruled that the Panel had applied the correct legal standard in reviewing the case and upheld the Panel's finding that the focus of the US administrative review should

[2] The AB report mentions three issues (see WT/DS138/AB/R at para. 43). However, items (b) and (c) in para. 43 of the report refer to the same underlying issue, namely the "pass through" of the benefits of the non-recurring subsidy upon the change in asset ownership.

have been on whether the subsidy had conferred a benefit on a particular legal entity and not on production *per se*. Furthermore, it found that no such benefit had been conferred on any existing legal entities, because the previously subsidized assets were sold by the government at market prices (para. 75).

5 The standard of review

The WTO regulates the standard of review that adjudicating bodies must apply when examining the conformity of actions taken by Members with the WTO contract. The review standards are discussed in two separate places in the WTO Agreement. First, Article 11 of the DSU discusses the general standards to be used in all disputes brought to the WTO except those covered by a specific rule. Second, Article 17.6 of the Anti-dumping Agreement provides specific rules governing the review of disputes arising from the application of antidumping policies. Article 17.6 is the only specific rule thus far included in the WTO contract that might be interpreted as an exception to Article 11 of the DSU.

The WTO has yet to clarify the operational differences between the standards of review required in disputes arising under the Anti-dumping Agreement and those to be applied in other disputes. But the wording of Article 17.6 of the Anti-dumping Agreement suggests that the Members may have wished the adjudicating bodies to adopt a more deferential attitude toward the actions of Members taken in response to perceived dumping than those taken for other reasons. In particular, Article 17.6(ii) of the Anti-dumping Agreement requires that when a panel

> finds that a relevant provision of the Agreement admits of more than one permissible interpretation, the panel shall find the authorities' measure to be in conformity with the Agreement if it rests upon one of these permissible interpretations.

In other words, if more than one interpretation of a term appearing in the Anti-dumping Agreement is possible, and if the domestic authority investigating the dumping claim adopted one of the admissible interpretations, then the ensuing actions should not be ruled illegal even if the WTO Panel would have preferred another interpretation of the ambiguous term. In contrast, Article 11 of the DSU, *prima facie*, does not seem to offer the same latitude. The article instructs a panel to

> . . . make an objective assessment of the matter before it, including an objective assessment of the facts of the case and the applicability of and conformity with the relevant covered agreements.

Arguably, this clause may require the WTO adjudicating bodies to decide on a single interpretation of terms in the WTO Agreement (outside of the antidumping area) and to outlaw all actions by domestic authorities that run counter to the preferred interpretation.[3]

Also germane to the US appeal is the Declaration on Dispute Settlement Pursuant to the Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994 or Part V of the Agreement on Subsidies and Countervailing Measures (the Declaration), which the WTO Members adopted in Marrakesh in the discussions that led to the conclusion of the Uruguay Round; and the Decision on Review of Article 17.6 of the Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994 (the Decision), which perhaps constitutes an attempt by the parties to give operational content to the Declaration. The Declaration advises the Ministers from the Member countries to

> [*r*]*ecognize*, with respect to dispute settlement pursuant to the Agreement on Implementation of Article VI of GATT 1994 or Part V of the Agreement on Subsidies and Countervailing Measures, the need for the consistent resolution of disputes arising from anti-dumping and countervailing duty measures.
>
> (italics in the original)

while the Decision instructs that the

> . . . standard of review in paragraph 6 of Article 17 of the Agreement on Implementation of Article VI of GATT 1994 shall be reviewed after a period of three years with a view to considering the question of whether it is capable of general application.

Apparently, the Declaration advises that disputes arising under the SCM Agreement should be adjudicated similarly to those arising under the Anti-dumping Agreement, and the Decision specifically requests that the WTO Members address the possibility of "exporting" Article of

3 Inasmuch as the WTO has not been called upon to clarify the practical differences between Article 17.6 of the Anti-dumping Agreement and Article 11 of the DSU, it is mere speculation that the former grants greater leeway to investigating authorities when responding to alleged instances of dumping than the latter clause leaves to such authorities in other matters.

17.6 of the Anti-dumping Agreement to disputes arising under the SCM Agreement.

The United States argued, in its appeal to the AB, that when the Members issued their Declaration calling for "consistent resolution of disputes," they meant to impose similar standards of review for disputes over countervailing duties and those concerning antidumping actions. The AB rejected this claim on four grounds. First, inasmuch as the language of the Declaration is hortatory, the AB argued that it has little if any legal significance, especially since it does not prescribe any particular course of action that should be followed in order to achieve the stated objective. Second, the failure of the WTO Members to take the action envisaged in the *Decision* within the indicated three-year time period suggested that the Members did not intend Article 17.6 of the Anti-dumping Agreement necessarily to be the standard of review in disputes involving countervailing duties.

Third, Article 1 of the DSU makes it clear that the rules reflected in that agreement, including its Article 11, should apply to all disputes brought to the WTO adjudicating bodies unless special or additional rules and procedures are spelt out in its Appendix 2. Whereas Appendix 2 of the DSU does in fact make reference to Article 17.6 of the Anti-dumping Agreement as an exception, it does not mention any special or additional rules that should regulate the standard of review of disputes arising from the SCM Agreement. Fourth, the AB argued that a precedent had been established in prior WTO jurisprudence to treat Article 11 of the DSU as the appropriate standard of review "for all but one of the covered agreements."

The decision reached by the AB on the issue of the appropriate standard of review seems to us to be the correct one. As the AB first noted in its report on *United States – Standards for Reformulated and Conventional Gasoline* (WT/DS2/AB/R of April 29, 1996) the WTO adjudicating bodies lack discretion as to the methods they can use when interpreting the WTO contract: the Members removed such discretion in Article 3.2 of the DSU, which requires the dispute settlement system of the WTO to interpret provisions of the various WTO agreements "in accordance with customary rules and interpretation of public international law." The customary rules of public and international law have been codified in Articles 31 and 32 of the Vienna Convention on Laws and Treaties (VCLT), which state that a treaty must be interpreted in accordance with the ordinary meaning of its terms in their context, taking into account the objectives of the treaty, any subsequent treaties or practice, and, when justified by the rules spelt out in Article 32 of VCLT, the preparatory work performed when the treaty was negotiated.

The ordinary meaning of the terms used in the Declaration, which was cited by the United States in its argument that Article 17.6 of the Anti-dumping Agreement ought to apply to the review of disputes arising under the SCM Agreement, supports the conclusion reached by the AB. First, the Declaration indeed is couched in hortatory language, and is, therefore, not legally binding. Where the Declaration states that the "Ministers *recognize the need* for the consistent resolution of disputes" (emphasis added), it clearly does not endorse or mandate any particular course of action. At most, the quoted phrase in the Declaration might be seen as a best-endeavors clause; that is, it might reveal the Members' intention to provide in subsequent actions the means to ensure consistency in the resolution of disputes under the Anti-dumping Agreement and the SCM Agreement.

An absence of legally binding language does not, however, immediately imply that there are no legal ramifications. Indeed, were the AB to interpret the Declaration outside of its context, it might have been forced to ask itself whether the Declaration provides sufficient normative guidance as to what actions are expected from the Members under the best-endeavors clause. However, the need for the AB to address this issue is obviated by the context of the Declaration itself.

The context of the Declaration includes at least the entirety of the WTO Agreement.[4] Thus, the Decision discussed by the AB in its report forms part of the context in which the Declaration must be interpreted. Since the WTO Agreement does not dictate any hierarchy of the two legal instruments, it is their terms and subject matter that must be used to determine which, if any, has priority. But we note that only the Decision prescribes specific actions that the Members should take to achieve the aims described in the Declaration. Moreover, the Decision discusses explicitly the possible "export" of Article 17.6 of the Anti-dumping Agreement to the SCM Agreement, whereas the Declaration does not.

Consequently, we consider it appropriate to regard the Decision as the procedural vehicle that the Members intended to be used in order to help realize the objectives expressed in the Declaration. The AB was correct to turn to the Decision for normative guidance. But when it did so, the AB

[4] It has sometimes been argued that other treaties relating to a similar subject matter, especially if they include as signatories more or less the same set of partners, can also form part of the legal context. The merits of this argument are irrelevant for the present analysis.

recognized that the specific action prescribed by the Decision for dealing with the possible use of Article 17.6 of the Anti-dumping Agreement in disputes arising under the SCM Agreement had not occurred within the specified time period. From this, the AB inferred that the Members did not intend to accomplish (at least for the time being) the aims spelled out in the Declaration, at least insofar as the application of identical standards of review, in disputes arising from the two different agreements concerned. We concur with this conclusion. Since the Members failed to review within three years the question of whether Article 17.6 of the Anti-dumping Agreement is capable of more general application, they could not have meant the objective of similar standards of review in the two types of disputes to be realized immediately.

When the Members failed to take specific actions to ensure identical standards of review, their lack of action warranted a resort to the status quo. But the status quo in this case is provided by Article 1 of the DSU, where it states that all rules in the DSU should apply to all disputes brought to the WTO adjudicating bodies unless special or additional rules and procedures are prescribed by Appendix 2. Since no new rule was articulated in the Declaration, the Decision, or in any subsequent legal instrument issued by the WTO Members, it follows that Article 11 of the DSU remains the relevant provision governing the standard of review in disputes arising under the SCM Agreement. The AB finding to this effect is well justified.

6 The "pass through" of non-recurring subsidies

The SCM Agreement allows a WTO Member to take countervailing action against imports when a foreign government provides a subsidy to its local producers and certain further conditions are met. The SCM Agreement defines a subsidy to be any financial contribution by a government to a specific enterprise, industry, or group of enterprises or industries that confers a benefit to the recipients. It allows countervailing measures when a Member can establish the existence of a subsidy so defined and can show that subsidized goods sold within its borders have caused or threaten to cause injury to a domestic industry.

As previously noted, the European Communities did not challenge the US claim that a (non-recurring) subsidy had been paid by the British government to British Steel Corporation at the time when the latter was a state-owned company. Nor did the United States contest the EC allegation that the divestiture of assets formerly owned by the British government was conducted at fair market prices. The contentious issue in this case has to do with the appropriate interpretation of the word "benefit" in the Agreement's definition of a subsidy. Does British Steel Engineering Steels now benefit from the equity infusions that were formerly granted to British Steel Corporation when the latter was a state-owned company?[5] If so, then the United States might be legally justified in levying a countervailing duty on imports of leaded bars from that company. If not, then no such countervailing measures are allowed.

In order to interpret the meaning of the word "benefit" in the context of the SCM Agreement, it is necessary to consider first the *raison d'être* of the Agreement itself.[6] Only by understanding the objectives of the Agreement and what behaviors it is meant to discourage can we discern how it ought to be applied in circumstances that are not explicitly discussed. We therefore begin with a discussion of why Members have decided to tolerate countervailing duties in response to certain subsidies, and why the imposition of such duties has been linked to the occurrence (or threat) of injury in a domestic industry.

6.1 Objectives of the SCM Agreement

Like any trade agreement, the SCM Agreement is meant to discourage governments from taking unilateral actions that would harm their trading partners. The presumption in international relations is that governments

[5] Recall that the United States argued in its appeal that the Panel should have considered whether a benefit was conferred to productive operations rather than to a legal or natural person. The AB rejected this claim, noting that Article 14 of the SCM Agreement refers to a "benefit to the recipient" and that prior jurisprudence by the AB has made clear that a benefit cannot exist in the abstract, but only if enjoyed by a beneficiary (i.e. a specific recipient). We will argue, however, that the distinction proposed by the United States between benefit to productive operations and benefit to a specific entity is of no legal consequence, once the term "benefit" is appropriately interpreted. In particular, we will argue that it is appropriate to consider a producer as having received a benefit anytime its production is competitively advantaged. With this definition of benefit, it makes no difference whether we look for benefit to productive operations or to specific producers. In either case, it is necessary to ask whether British Steel Engineering Steels enjoys any competitive advantage from the subsidies previously paid to British Steel Corporation, considering that the current owners of British Steel Engineering Steels purchased the assets of British Steel Corporation at fair market prices.

[6] As previously noted, Article 31 of the VCLT requires that the terms in an international treaty be interpreted in, and not independent of, their context. In its past decisions, the AB routinely has endeavored to interpret the terms of the WTO Agreement in their context; see, for example, the AB report *United States – Definitive Safeguard Measures on Imports of Circular Welded Carbon Quality Line Pipe from Korea* (WT/DS202/AB/R of February 15, 2002) at § 165.

can do as they choose with regard to policies whose effects are confined within their borders. But many policies – domestic as well as trade policies – impinge upon the interests of foreign citizens and corporations. In the absence of any agreements, governments might have little reason to take these "international externalities" into account when setting their national policies.

Policies that are set without regard to their potentially adverse effects abroad are bound to be globally inefficient, in the sense that an alternative set of policies could be found that all governments would agree is preferable to the chosen ones. To further global efficiency, a trade agreement makes it costly for a government to choose policies that inflict harm on trading partners. Countervailing duties are the primary instruments in the SCM Agreement for imposing costs on a government that chooses to invoke subsidies.

Why do the Members of the WTO wish to discourage certain subsidies? This question is the same as asking "in what ways might a subsidy inflict 'harm' on another Member country?" The answer to this question depends, of course, on the interpretation of the word "harm." The appropriate application of the treaty – including, for example, to situations in which subsidized assets have undergone a change in ownership – should be one that helps to avoid the sort of harm that was of concern to the signatories.

One possibility would be to associate harm with a loss of aggregate economic welfare. That is, we might assume that the parties to the SCM Agreement wished to discourage subsidies, because they feared that such policies would reduce the sum of consumer surplus, producer surplus, and government revenue in other Member countries. If this indeed were the objective of the treaty, then the application of countervailing measures should be sanctioned only for cases in which a subsidy can be shown to inflict a welfare loss on another Member. We argue, however, that an interpretation of the SCM Agreement that associates harm with a loss in aggregate economic welfare cannot be sustained in the light of the manner in which the Agreement was structured.[7]

[7] Goetz, Lloyd, and Schwartz (1986) and Diamond (1989) consider the rationale for countervailing duty law and conclude that these laws are best understood as a means to protect an entitlement of domestic producers from the harmful effects of foreign subsidies rather than as a means to promote global economic efficiency. Our understanding of the SCM Agreement is quite similar. We do not mean to imply, however, that a welfare standard for injury tests would be the wrong standard to use. To the contrary, we believe that an alternative injury test that looked for harm to aggregate welfare would better serve the objective of promoting international efficiency than the test required in the SCM Agreement as it now stands. We come back to this point in section 6.3.6, when we discuss the desirable changes to the SCM Agreement that are suggested by this case.

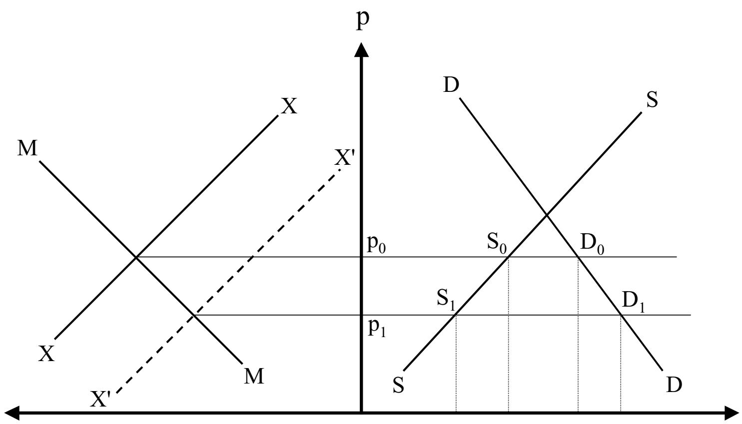

Figure 8.1

As is well known, if product and factor markets are competitive and well-functioning, then a foreign subsidy to production of a good cannot reduce aggregate welfare in an importing country. This point can be seen with the aid of figure 8.1. In the figure, the left side shows the world market for the good before and after the subsidy is introduced. The curve XX is the original excess supply curve in the country that implements the subsidy. This curve gives, for each world price, the amount that the country's firms produce in excess of what is demanded by local consumers. This corresponds to the volume of its exports at the given price. The curve MM is the aggregate excess demand curve of the rest of the world; it is the excess of world demand outside the subsidizing country over the aggregate production at each price. The world equilibrium without subsidies is found at the intersection of the two curves, where the excess supply of the one country matches the total excess demand of the others. The no-subsidy world price is p_0.

A subsidy typically encourages production in the subsidizing country.[8] Thus, at each price, local firms are willing to produce more output when subsidized than otherwise. It follows that the subsidy shifts the excess supply curve of the subsidizing country to the right, as depicted for example by X′X′. As can be seen in the figure, the effect of the subsidy is to reduce the world price of the subsidized good.

The right side of the figure shows the impact of the subsidy in a country that imports the good. The effects of the subsidy are transmitted to the

[8] We will clarify this point below, distinguishing in particular between recurring and non-recurring subsidies.

importing country via the fall in the world price. The demand curve in the importing country is labeled DD, while the supply curve is labeled SS. At both p_0 and p_1, the quantity demanded exceeds the quantity supplied, which implies that the good is imported from abroad.

We can now find the effects of the subsidy on aggregate welfare in the importing country. First, consumers benefit from the lower price. The gain in consumer surplus is given by the area of the trapezoid $p_0p_1D_1D_0$. It includes both the savings to consumers on the D_0 units that they consumed before the subsidy was introduced, and the difference between their willingness to pay for the D_1-D_0 extra units they purchase after the price decline and what those units cost them.

Producers, meanwhile, are hurt by the fall in price. The loss in producer surplus is equal to the area of $p_0p_1S_1S_0$. This includes both the loss of revenue on the S_1 units that they produce after the subsidy is in place but sell for a lower price than beforehand, and the surplus relative to marginal cost that they earned on the units that no longer are produced once the subsidy is introduced. The figure shows that the harm to producers can never be as large as the benefit to consumers; in total, the country gains surplus equal to the area of $S_0D_0D_1S_1$. If markets were competitive and well-functioning in the importing countries and governments were concerned only about aggregate economic welfare, then importing countries would be thankful when a trading partner introduced a subsidy, and would have no reason to discourage such subsidies with the threat of countervailing actions.

Of course, it is not true that a subsidy always enhances aggregate welfare in all Member countries. It is simple to see, for example, that a subsidy will reduce welfare in a country that exports products that compete with the subsidized good. Figure 8.2 reproduces the left side of figure 8.1, but shows on the right side the effects of the subsidy in a country that exports a good in competition with the country that has implemented the subsidy. In such a country, consumers gain an amount equal to the area of $p_0p_1D_1D_0$ while producers lose an amount equal to the area of $p_0p_1S_1S_0$. Here, the producer loss outweighs the consumer gain.

Aggregate welfare losses might sometimes occur in an importing country as well. Let us reconsider, for example, the situation depicted in figure 8.1, but suppose this time that wages are rigid (or sticky) in the country that imports the subsidized good. In other words, instead of a "well-functioning market" we imagine that there are imperfections in the importing country's labor market. Then the reduction in output induced by the foreign subsidy will be accompanied by an increase in unemployment in the importing country. As usual, the supply curve SS gives the

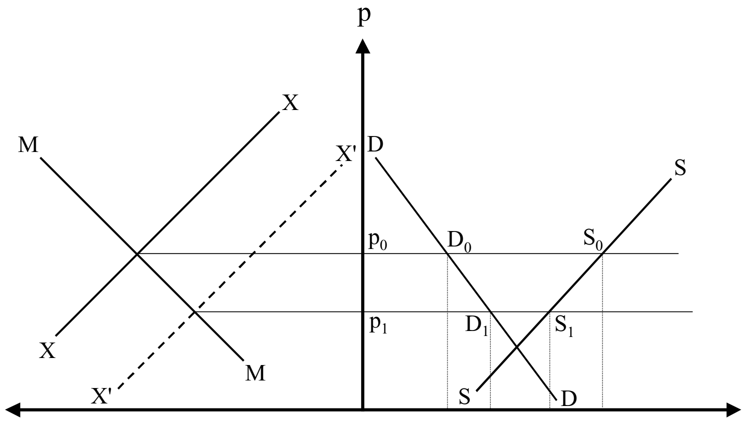

Figure 8.2

private marginal cost of production in the importing country, including the entirety of the wage bill. But, with wage rigidities, the social cost of output is less than the private cost, because the workers in the industry do not have the opportunity to earn a similar wage elsewhere in the economy. Since the social cost is less than the private cost, $p_0p_1S_1S_0$ represents an understatement of the loss in producer surplus caused by the foreign subsidy. If the social loss is large enough, it can outweigh the benefit to consumers.

A foreign subsidy can also reduce aggregate welfare in an importing country when a few large firms dominate the industry. In such circumstances, the firms (foreign and domestic) may exploit their market power by charging prices in excess of marginal production costs. As Brander and Spencer (1985) have shown, subsidies can have strategic effects on firm behavior in markets with imperfect competition. If a subsidy causes foreign firms to sell more output than otherwise, the optimal response of competitors in the importing country may be to reduce the volume of their own sales. But this will spell a loss of monopoly profits for the domestic firms, which will offset and perhaps outweigh the net benefit depicted in figure 8.1.[9]

[9] A predatory subsidy is an extreme example of a strategic subsidy. The intent of such a policy is more than just to induce firms outside the subsidizing country to cede market share, but actually to drive them from the market. Like strategic subsidies, predatory subsidies can reduce aggregate welfare in an importing country, both because the local producers that leave the industry forfeit their prospective profits, and because the consumer price may rise once the local competitors exit.

We conclude that the effect of a subsidy on aggregate welfare in another Member country is *a priori* ambiguous. Therefore, if the Members had intended the SCM Agreement to discourage actions that would inflict welfare losses on others, they would have directed the "test" for actionable subsidies toward identifying conditions where aggregate loss is most likely to occur. For example, an external welfare loss is more likely to occur when a government subsidizes firms that sell in an imperfectly competitive market. So the test for an actionable subsidy might have made reference to the competitive conditions of the subsidized industry. Similarly, a welfare loss is more likely when wages are sticky in the importing country than when they are flexible; so the Agreement might have made reference to the labor-market conditions there. The Agreement might also have allowed for countervailing measures in Member countries that export goods in competition with the subsidized good, inasmuch as these countries are quite likely to suffer welfare losses as a result of a foreign subsidy.

In fact, the SCM Agreement does not confine the use of countervailing duties to situations in which an importing country has established the presumption of a welfare loss. The Agreement makes no reference to labor-market conditions, to market structure, or even to consumer welfare. And the Agreement makes no allowance for countervailing measures in countries that export the subsidized good, where the presumption of welfare losses surely exists.[10] Rather, countervailing measures are permitted only when there has been (or threatens to be) injury to a domestic industry in an importing country.

The observation that injury to import-competing interests provides the sole basis for countervailing action points to a different interpretation of the objective of the SCM Agreement. Evidently, the signatories meant to discourage certain policy actions that would harm competing *producer*

[10] Although the Agreement recognizes the possibility of serious prejudice to the interests of another Member that may arise due to the displacement of exports of a like product to the market of the subsidizing member or to a third-country market, it does not allow serious prejudice to exporting interests to be a basis for countervailing action. Rather, in such cases, the Agreement calls for consultations between the Member that is granting or maintaining a subsidy and the complaining Member, followed by a panel review in the event that consultations do not result in a mutually agreed solution. Only after a report by a panel or Appellate Body has been adopted in which it is determined that a subsidy has resulted in adverse effects to the interests of another Member and the subsidizing Member has failed to take appropriate steps to remove the adverse effects of the subsidy may the complaining Member take such countermeasures as have been authorized by the Dispute Settlement Body (see Articles 7.8 and 7.9 of the SCM Agreement).

interests in the importing country. This objective is understandable in the light of recent literature on the political economy of trade policy, which has emphasized that governments often set their trade policies with objectives other than the maximization of aggregate economic welfare in mind. The policies that are chosen typically reflect a compromise among competing constituent interests. Moreover, some interests – especially those that are relatively concentrated – receive more weight in the political process than others. Less concentrated groups are not so successful in the political arena, in part because they have difficulty in overcoming the free-rider problems that plague collective political action (Olson, 1965). Thus, governments often are induced by political pressures to give more weight to producer interests than to consumer welfare when making their decisions about trade policy.

Our interpretation that the main objective of the SCM Agreement is to discourage subsidies that might harm producers in importing countries finds support in many other provisions of the Agreement. For example, Article 12.9 specifies that the domestic producers of a like product *must* be invited by the investigating authority to offer their views about an alleged subsidy and proposed countervailing measures, whereas the authority has discretion to decide whether or not to allow consumers of the subsidized good to do so. Article 15.1 requires that "a determination of injury . . . shall be based on positive evidence and involve an objective examination of both (a) the volume of the subsidized imports and the effect of the subsidized imports on prices in the domestic market for like products and (b) the consequent impact of these imports on the domestic producers of such products." And Articles 14 and 19 require the size of the countervailing duty to be set so as to just offset the adverse effects of the subsidy on conditions in the domestic industry. This latter provision can only be understood as an attempt to restore competitive conditions in the industry to what they would have been had the subsidy been absent.

6.2 Subsidy benefits and changes in ownership

We return now to the central issue in *US – Lead and Bismuth II*, which concerns the appropriate interpretation of the term "benefit" where it is used in Article 1.1(b) of the SCM Agreement in the definition of an actionable subsidy. Bearing in mind that the objective of the SCM Agreement is to discourage governments from enacting policies that might harm producer interests in importing countries, the definition of a subsidy must be one that helps to identify policies that would inflict such harm. Accordingly, "benefit" must be evaluated in terms of the effect of the policy on the competitive position of the firm or firms that (directly or indirectly) received the government's contributions, rather than in terms of the effect of the contributions on the profits or wealth of the owners of those firms.

In *US – Lead and Bismuth II*, the AB was called upon to decide the legitimacy of continued US countervailing duties following a change in ownership. The European Communities claimed that, because the current producers in the United Kingdom had acquired the assets of British Steel Corporation at fair market prices, they could not have received benefits from any prior subsidies. The United States countered that the original subsidy continued to favor British production of the exported products, even if the current owners of the assets had not profited personally from the purchase of those assets.

As previously noted, the AB ruled in favor of the European Communities on this central issue in the case. It found that the "financial contributions" to British Steel Corporation had conferred no "benefit" to United Engineering Steels Ltd. or to British Steel plc/British Steel Engineering Steels and that, in consequence, the US application of countervailing duties on the lead bar products was inconsistent with its obligations under the SCM Agreement. In particular, the AB argued that

> [t]he question whether a "financial contribution" confers a "benefit" depends, therefore, on whether the recipient has received a "financial contribution" on terms more favorable than those available to the recipient in the market. In the present case, the Panel made factual findings that UES and BSplc/BSES paid fair market value for all the productive assets, goodwill, etc., they acquired from BSC and subsequently used in the production of leaded bars imported into the United States in 1994, 1995 and 1996. We, therefore, see no error in the Panel's conclusion that, in the specific circumstances of this case, the "financial contributions" bestowed on BSC between 1977 and 1986 could not be deemed to confer a "benefit" on UES and BSplc/BSES.

We find this ruling to be wholly misguided, inasmuch as the Appellate Body's interpretation of the treaty text fails to accord with the clear intentions of the signatories of the SCM Agreement. Because the SCM Agreement fails to provide an explicit definition of the term "benefit," the adjudicating bodies are left to interpret the term on a case-by-case basis. But each such interpretation must be consistent with the overall objectives of the Agreement. We have already described the nature of those objectives; i.e. the Members wished to discourage governments from invoking subsidies when such policies would bring harm to producer interests in an importing country.

Since the signatories wished to avoid potentially adverse effects of a subsidy on producers in an importing country, then surely the appropriate question to ask in this case is whether the US producers continue to be disadvantaged relative to what would have been their competitive situation *but for* the subsidies paid to British Steel Corporation. This perspective provides the necessary guidance for interpreting the term "benefit" in this case; a benefit existed in the period under administrative review if and only if the British producers of leaded bars enjoyed a privileged position in the industry thanks to some enduring effects of the government's contributions.

We note that a change in ownership – at fair market prices or otherwise – has no bearing on competitive conditions in the world market for leaded bars. The British supply of exports is the difference between the British industry's supply of leaded bars and the local demand for those products. The industry supply, in turn, reflects the producers' marginal costs of production. Whereas the existence of the assets transferred by British Steel Corporation to United Engineering Steels Ltd. and then sold to British Steel plc/British Steel Engineering Steels may have affected the conditions of British supply in the periods under review, the amount that was paid in each transaction affected only the distribution of wealth among shareholders. Evidently, the AB interpreted "benefit" in the sense of "adding to wealth": the owners of British Steel plc/British Steel Engineering Steels are no wealthier today than they would have been had no contribution been made to British Steel Corporation. But the interpretation of the term "benefit" as an addition to wealth cannot be sustained in the context of the SCM Agreement. Accordingly, the observation that the assets were divested by the UK government at fair market price is irrelevant to the determination of whether the original subsidy conferred a benefit to the current producers of leaded bars that continues to impact adversely the producers of like products in the United States.[11]

[11] David Palmeter has made an additional excellent point to us in private discussions. If a change in ownership at fair market prices were sufficient to extinguish the benefits of a subsidy under countervailing duty law, then not only privatization but also equity sales between private citizens would have this effect. Since many shares of publicly traded firms change hands each year, a government's legal right to countervail against foreign subsidies would quickly be eliminated by such private changes in ownership.

6.3 Administrative review of non-recurring subsidies

The fact that the AB misinterpreted the term "benefit" in its ruling on *US – Lead and Bismuth II* does not, however, validate the US claim that it fulfilled its obligations under the SCM Agreement when it conducted its administrative reviews of the countervailing duties on leaded bars. Even with an appropriate interpretation of benefit as anything that provides a competitive advantage to foreign producers, it is incumbent upon the importing country to review periodically the ongoing need for a countervailing duty (see Article 21.2 of the SCM Agreement).

Here, the Agreement calls for the authorities, where requested, to "examine whether the continued imposition of the duty is necessary to offset subsidization, whether the injury would be likely to continue or recur if the duty were removed or varied, or both." In other words, the investigating authority must review whether the exporting entities continue to reap benefits from the subsidy, within the meaning of this term that we have already discussed. In fact, the investigating authorities in the United States made no effort to examine this issue when they conducted their administrative reviews in 1994, 1995, and 1996. Accordingly, they failed to establish the legality of continued imposition of countervailing duties on leaded bars from the United Kingdom.

What obligations did the SCM Agreement impose on the US investigating authorities when they conducted their administrative reviews of the countervailing duties on leaded bars? In order to answer this question, it is necessary for us to elaborate the essential differences between a recurring subsidy and a non-recurring subsidy, a topic to which we now turn.

6.3.1 Market effects of recurring subsidies

A recurring subsidy is one that provides for ongoing financial transfers from the government, often in relation to some economic activity or variable. Examples include fiscal incentives for employment or output and public provision of goods and services at below market prices.

It is easy to see how a recurring subsidy can promote exports, and how the subsidized exports can cause harm to a domestic industry in the importing country. Take, for example, the case of a fiscal inducement to production. Under such a scheme, foreign firms producing the subsidized product receive an amount s per unit of output from their government in addition to the price p they collect from the sale of the products. In the left panel of figure 8.3, we show the pre-subsidy supply and demand curves for

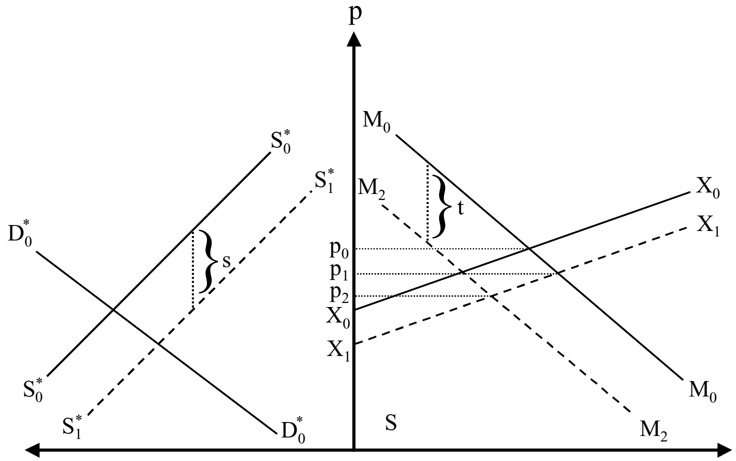

Figure 8.3

the subsidized product in the foreign country, $S_0^*S_0^*$ and $D_0^*D_0^*$, respectively. The subsidy shifts the foreign supply downward by an amount s, because foreign firms are willing to sell a given quantity at a lower international price when a subsidy is offered in view of the extra compensation they will receive from their own government. The supply curve that prevails with the subsidy in effect has been labeled $S_1^*S_1^*$ in the figure.

The effect of the subsidy on the world price is depicted in the right side of figure 8.3. Export supply at any world price p is the difference between supply and national demand at that price. The foreign country's pre-subsidy export supply curve is depicted by X_0X_0, whereas the subsidy causes the curve to shift to X_1X_1, with a vertical displacement that is less than or equal to s. The curve typically shifts by less than s, because the output subsidy serves to promote foreign production whereas an equivalent fall in the price p would both reduce foreign supply and boost foreign demand.[12] The subsidy induces a decline in the world price and an increase in the volume of exports, as we have noted previously.

The fall in world price spells injury to competing industries in the importing countries. But the injurious effects of the subsidy can be offset with a countervailing duty. Consider, for example, a per-unit tariff of size t, where t is set equal in magnitude to s. A tariff of t would shift the import demand vertically by an amount t, so that the import demand curve with the countervailing duty in place would be the one depicted by M_2M_2. The

[12] The vertical displacement of the export supply curve would be exactly equal to s if foreign demand for the product were totally unresponsive to price.

figure shows the new (net of tariff) world price as p_2, where $p_2 \geq p_0 - s$. The gross price in the importing country is $p_2 + t$, which therefore exceeds p_0. Thus, a countervailing duty set equal in size to the per unit subsidy to foreign output is (more than) enough to restore a domestic price in the importing country greater to what it would have been *but for* the subsidy. It follows that a countervailing duty of size t leaves the domestic industry in the importing country at least as well off as it would have been without the foreign subsidy.[13]

It is apparent that a continuing countervailing duty would be needed to offset the ongoing benefit to foreign firms of a recurring subsidy. Were the duty to be removed at any time while the subsidy remained in place, the equilibrium world price would revert to p_1 and producers in the importing country would fare worse than at p_0, the price that would prevail in the absence of a subsidy.

6.3.2 Market effects of non-recurring subsidies

A non-recurring subsidy, by contrast, is a government contribution that is paid only once or perhaps a limited number of times. Usually, such contributions are used to finance wholly or partially the acquisition of fixed assets such as technology, plant, and equipment. Contributions that fall into the category of non-recurring subsidies include cash grants, loan guarantees, equity infusions, and government loans at below market interest rates. The SCM Agreement does not draw any legal distinction between recurring and non-recurring subsidies. It allows for countervailing duties when a Member establishes the existence of a subsidy of any sort and shows that subsidized imports are causing or threaten to cause injury to a domestic industry producing like products. The Agreement stipulates that the duties should not exceed the full amount of the subsidy, calculated as the benefit received by the exporting firm or industry per unit of the subsidized and exported product.

The countervailing duties at issue in *US – Lead and Bismuth II* were imposed, as we have indicated, in response to non-recurring subsidies. The US Department of Commerce found that the British government had provided equity infusions and cash grants to British Steel Corporation totaling £7 billion between 1977 and 1986. According to the United States, these contributions were used to finance investments by British

13 If there were more than a single importing country, this conclusion would be strengthened, because then the aggregate world import demand curve would shift with the tariff by an amount less than *s*.

Steel Corporation that allowed the company to develop capacity for producing leaded bars. The United States has made no claim that the British government continues to make contributions to the firms or industry on an ongoing basis.

According to our discussion above, the investigating authorities in the United States are obliged under the terms of the SCM Agreement to show that the current producers of leaded bars in the United Kingdom are benefiting from the subsidies that were paid to British Steel Corporation. With our interpretation of "benefit" as anything that gives foreign firms a competitive advantage, the investigating authorities should have asked how (if at all) the industry competition differed in the review period from what would have been the competitive situation *but for* the earlier payment of the non-recurring subsidies.

To see the issues involved, we discuss the impact of a non-recurring subsidy on subsequent industry competition and show how a countervailing duty can be used to offset the adverse effects of such a subsidy on competing interests in an importing country. First, let us consider a non-recurring subsidy that is offered to help finance fixed-scale investments by one or more foreign firms. A fixed-scale investment is one in which the firms face a dichotomous decision; they can either choose to undertake a project of some predetermined size or to forego it entirely. Examples of such investments might include an R&D project to design a new product or a project to build a new manufacturing facility at minimum efficient scale.

Under such circumstances, the subsidy will change competitive conditions in the industry, at least initially, if one or more of the firms in the industry that would not have undertaken the project absent the subsidy decides differently in response to the government's contribution. Clearly, the subsidy can cause more foreign firms to be active in the industry than would otherwise be the case, or it can cause them to produce at greater scale. The initial effects of such a non-recurring subsidy, which were depicted in figure 8.1, include an increase in exports and a fall in the world price of the subsidized good. The fall in world price may well cause injury to firms in the domestic industry.

Next we consider the initial effects of a non-recurring subsidy that is used to help finance investments that may vary in size. For such investments, firms must choose not only whether to pursue the indicated projects, but also at what level to invest. For example, when a firm installs capital equipment, it must decide how much machinery to purchase, perhaps trading-off the fixed cost of the machines against the potential savings in labor costs. In a simple example, the government might offer to pay a fraction of firms' investments in machinery and equipment.[14]

Firms then would choose their levels of investment to maximize profits net of investment costs. The benefits would come in the form of reduced labor costs. The smaller is the fraction of the total investment cost that the firms must bear themselves, the greater will be the scale of investment that equates marginal benefit with marginal cost (to the firm). The direct effect of a non-recurring subsidy is to increase the scale of investment, which in turn has an indirect effect of lowering firms' marginal production costs. Since profit-maximizing firms supply output up to the point where the marginal cost is equal to the market price, they will supply more output at a given price level and their marginal costs will be lower. It follows that a non-recurring subsidy that induces extra investment also shifts the foreign industry supply curve, ultimately reducing the world price of the subsidized good. Again, producers in the importing country who must compete with the subsidized good may suffer as a result.

6.3.3 Injury determination

Having established that a non-recurring subsidy can cause harm to a domestic industry in an importing country producing a like product, we proceed now to discuss the conditions that must be met before a country can introduce a countervailing duty order and (in the next subsection) the requirements under the SCM Agreement for periodic review of such orders.

As previously noted, the SCM Agreement requires an injury determination before any countervailing duties are imposed. Article 15.1 mandates:

> A determination of injury for purposes of Article VI of GATT 1994 shall be based on positive evidence and involve an object examination of both (*a*) the volume of the subsidized imports and the effect of the subsidized imports on prices in the domestic market for like products and (*b*) the consequent impact of those imports on the domestic producers of such products.

Article 15.5 further stipulates:

> It must be demonstrated that the subsidized imports are, through the effects of subsidies, causing injury within the meaning of this Agreement. The demonstration of a causal relationship between the subsidized imports and the injury to the domestic industry shall be based on an examination of all the relevant evidence before the authorities.

[14] Loan guarantees, loans at below market rates of interest, and infusions of equity that would not be forthcoming from private investors work similarly.

US trade law calls on the US International Trade Commission to conduct an investigation in which it must determine whether an industry in the United States has been materially injured or threatened with material injury *by reason of imports of the subsidized merchandise.*[15]

Evidently, the SCM Agreement requires the investigating authority to resolve a question of causality. To do so, it must invoke a hypothetical comparison between the various indicators of industry health – output, employment, profits, etc.[16] – and what the situation in the industry would have been had the non-recurring subsidy never been granted. The authority can only determine that the subsidy has caused injury if it finds that investments have taken place that would not have occurred but for the foreign government's policies, that the investments have improved the competitive position of the subsidized producers, and that the resulting shift in the foreign supply has been responsible for a deterioration in the performance of the US industry that produces a like product.[17]

6.3.4 Administrative review

The requirements for an administrative review are similar. According to Article 21.1 of the SCM Agreement,

> A countervailing duty shall remain in force only as long as and to the extent necessary to counteract subsidization which is causing injury.

Clearly, it is not enough for an investigating authority to have shown that a non-recurring subsidy caused injury sometime in the past. Rather, the use of the present tense in the subordinate clause obliges the investigating authority to demonstrate continuing injury that can be attributed to the subsidy.

The first and most difficult question that should be raised in any such review of a non-recurring subsidy is whether the level of capital (physical

[15] See Subtitle A of title VII of the Tariff Act of 1930, as added by the Trade Agreements Act of 1979 (19 U.S.C. § 1671 et seq.) and subsequently amended.

[16] Article 15.4 of the SCM Agreement stipulates that "the examination of the impact of the subsidized imports on the domestic industry shall include an evaluation of all relevant economic factors and indices having a bearing on the state of the industry, including actual and potential decline in output, sales, market share, profits, productivity, return on investments, or utilization of capacity; factors affecting domestic prices; actual and potential negative effects on cash flow, inventories, employment wages, growth, ability to raise capital or investments . . ."

[17] Goetz, Granet, and Schwartz (1986) and Diamond (1989) also have stressed the need for counterfactual analysis in determining whether foreign subsidies have caused injury to domestic producers.

and intangible) invested in the industry remains higher than it would have been but for the subsidy. The current US practice, which involves no such inquiry, implicitly assumes that the extra investment induced by a subsidy will remain "marginal" – that is, above and beyond what would have occurred without the subsidy – no matter how industry conditions evolve subsequently. But this assumption is not justified. Events in an industry may cause investments that were marginal at the time they were made to become inframarginal thereafter.

We illustrate with an example. Suppose a foreign government has provided a low-interest loan to finance the construction of a new plant. Suppose further that the investment would not have been economically justified without the government's contribution, i.e. the discounted profits that the producer could expect to derive from the plant were insufficient to cover the private cost of the investment at the time of construction. Surely, in the period just after the new plant came on line, the foreign industry had a greater level of output than would have been the case but for the subsidy. For this reason, the subsidy may well have caused some injury to a US import-competing industry.

But now suppose that consumer demand for the industry's output grows in the following years at a rate that exceeded the original expectations. The increased demand may have caused industry conditions to improve to such an extent that it would have been profitable for a foreign producer to build the extra plant even without the inducement of the subsidy. When that happens, it is no longer true that the subsidy is responsible for competitive conditions different from those that would have prevailed in the hypothetical, but-for world. A plant that was marginal at the time of its construction can become inframarginal in the light of subsequent events.

An administrative review of a countervailing duty order for a nonrecurring subsidy routinely should ask the question "is the foreign production advantaged in the review period relative to what it would have been had the subsidy never occurred?" Answering this question in the current case would require a counterfactual analysis of what investments would have taken place in the years since British Steel Corporation received its grants and equity infusion from the British government. If the foreign export supply of the lead bar products remains greater (at a given price) than it would have been but for the subsidy, then the United States would be well justified in continuing to countervail its adverse effects on the US industry. But if the "benefits" from the subsidy to British production have evaporated over time due to changed economic conditions in the steel industry, then the countervailing duty ought to be eliminated.

6.3.5 Where did the Appellate Body go wrong

As we have argued earlier, the Appellate Body erred in its interpretation of the word "benefit." Had it been correct to understand the word benefit to mean an increase wealth, then it also would have been correct to examine whether the current owners of the British Steel Corporation assets had acquired these assets at fair market prices. But with the appropriate understanding of benefit as a boost to the British firm's competitive position, the relationship between the price paid by the current owners for the British Steel Corporation assets and the fair market price is not germane to the analysis. It is possible that the current owners paid a fair price for the British Steel Corporation assets and still the firm has benefited in regard to its competitive condition, because the investment remains inframarginal in the sense that the capital stock would not be the same today had there never been a subsidy. Conversely, it would also be possible in other circumstances for private agents to acquire once-subsidized assets from the government at below market prices, and yet the assets could be seen as causing injury to a domestic firm, because the assets no longer can be considered as inframarginal.

We illustrate these points with a pair of constructed examples. Suppose first that a government G made equity infusions in 1990 into a publicly owned company C. The company used the capital so contributed to purchase 1,000 Euros-worth of machinery. Suppose further that, had a profit-maximizing private company faced a similar commercial opportunity, it would only have invested 500 Euros in view of the prevailing market cost of raising capital. Clearly, the subsidy initially was responsible for an extra 500 Euros of investment. The extra machinery presumably meant extra output, and potentially caused harm to a competing industry in an importing country.

Now suppose that market conditions remain exactly the same between 1990 and 1995 and that machines purchased by C suffer no depreciation. In 1995, these machines are worth 800 Euros, less than the 1,000 Euros that C paid for them. Now if C sells the machines to a private buyer B for the market price of 800 Euros, this transaction does not negate the benefit to B from the original subsidy. Had there never been a subsidy, only 500 Euros of investment would have taken place. Then B would only have been able to purchase the 500 Euros-worth of machinery from C in 1995. Since the subsidy caused an extra investment of 500 Euros, the competitive position of B in the world market is better in 1995 than it would have been absent the subsidy. And firms in the importing country may still be suffering injury as a result.

The facts of our second illustrative example are similar as concerns the initial subsidy and investment in 1990. But now we suppose that between 1990 and 1995 there has been robust growth in demand for the output of Company C and other firms selling like products. By 1995, additional investments have taken place in the industry, and the original investment of 1,000 Euros has been justified by subsequent market developments. In other words, a private company that would have invested only 500 Euros in 1990, would by 1995 have purchased the additional machines in response to the subsequent market growth. Indeed, in our example, the machinery purchased by C in 1990 has a market value of 1,500 Euros in 1995, thanks to the improved conditions in the industry. Now, even if we observe that B has purchased the machines from C in 1995 at the below market price of 1,000 Euros, there is no injury to competing firms in the importing country that can be attributed either to the original equity infusion or to the subsidized sale of the public assets. Absent these subsidies, market conditions in the industry and the sales, profits, and employment of competing firms would have been much the same as they are in reality. Therefore, the importing country would not be justified in continuing its countervailing duty following an administrative review in 1995.

6.3.6 Must the SCM Agreement be modified?

In principle, WTO Panel and Appellate Body reports are directed only to specific addressees, namely the parties to the dispute.[18] However, the WTO adjudicating bodies do often cite prior case law to support the reasoning they have used to reach a decision. Thus, AB reports do sometimes set precedents that – although not legally binding – have real effects on subsequent dispute resolution.

The WTO adjudicating bodies have, on several occasions, ruled that the resale of subsidized assets at arm's length and at fair market prices

[18] In Article 19 of the DSU, the parties have agreed that "where a panel or the Appellate Body concludes that a measure is inconsistent with a covered agreement, it shall recommend that the Member concerned bring the measure into conformity with that agreement." This language would seem to suggest that the panel and Appellate Body decisions are not binding on other parties with seemingly similar circumstances.

extinguishes the benefits of a non-recurring subsidy.[19] We believe that these adjudicating bodies have repeatedly misinterpreted the meaning of the term "benefit." We have supported our case not with arguments about what the text "should have said" but rather with reference to the text of the SCM Agreement itself, and its intended meaning. Accordingly, we do not believe that any modification of the existing legal instrument is necessary in order that the adjudicating bodies apply an interpretation of the term benefit that is consistent with the economic principles embodied in the Agreement.

However, we do favor a modification of the SCM Agreement that would render the injury test in subsidy cases more in line with the principles of welfare economics. As we have noted previously, the text of the Agreement leaves little room for interpreting the requisite injury test in welfare-economic terms. The wording of the Agreement is quite clear that, to invoke a countervailing duty, a Member must show that subsidized imports are causing injury to domestic producers of a like product, and nothing further. In our view, the SCM Agreement would better serve the objective of promoting efficiency in trade relations if Members were limited in their application of countervailing measures to circumstances in which they demonstrated that foreign subsidies have been damaging to aggregate economic welfare. In cases where a foreign subsidy does no such harm but does adversely impact certain interests in the importing country, it ought to be the responsibility of the importing country to effect the domestic redistributions that make the losers whole.

7 Conclusions

In this review, we have argued that the AB applied a faulty interpretation of the term "benefit" in its report on *US – Lead and Bismuth II*. The AB ruled that a company that purchases assets at fair market value cannot benefit from a subsidy that was paid at an earlier time to facilitate the acquisition of those assets. Although we agree that the acquiring company cannot *profit* by purchasing assets at a fair market price, its competitive position in the industry nonetheless can be advantaged relative to what it would have been "but for" the subsidy. The signatories of the SCM Agreement were concerned with injury caused by subsidies. Accordingly, an interpretation

[19] Most recently, in *United States – Countervailing Measures Concerning Certain Products from the European Communities* (see WT/DS212/R), the Panel ruled that a privatization at arm's length and for fair market value extinguishes the benefit to the privatized producer of a subsidy that was paid to the original owner of the privatised assets (July 31, 2002).

of "benefit" as something that improves a firm's or industry's competitive position is more consistent with the intentions of those who signed the agreement.

Our conclusion regarding the AB ruling does not exonerate current US practice in its administrative reviews of countervailing duty orders. An administrative review that is consistent with the obligations imposed by the SCM Agreement should pose the counterfactual question, is the importing-competing industry injured relative to what its economic health would have been "but for" the non-recurring subsidy? Since the AB ruled, in effect, that there was no continuing subsidy after the privatization of the British Steel Corporation assets, it did not address the question of what injury test should be used in an administrative review of a non-recurring subsidy.

We summarize our conclusions as follows:

(i) The AB ruled correctly that the Panel applied an appropriate standard of review according to Article 11 of the DSU.

(ii) The AB ruled incorrectly that a change in ownership of assets at fair market value provides per se evidence of an absence of subsidy, because it precludes "benefit" to the acquiring firm.

(iii) A consistent interpretation of the SCM Agreement calls for a "but for" test for continuing injury from a non-recurring subsidy. The authorities in the importing country should periodically review whether its domestic producers of like products are suffering harm relative to what would be their economic condition but for the prior non-recurring subsidy. To effect this test, the authorities must ask whether or not the subsidized investments have become inframarginal in the light of subsequent events in the industry.

(iv) No modification of the existing legal instrument is needed for the *Agreement* to be interpreted in a manner consistent with the economic principles raised by this case.

8 Postscript

Subsequent to its ruling in *US – Lead and Bismuth II*, the WTO Appellate Body reversed its position that a government's sale of assets at fair market prices necessarily extinguishes the benefits from a non-recurring subsidy. In its report on *US – Countervailing Measures on Certain EC Products*, the Appellate Body ruled (see para. 7.127) that

> the Panel erred in concluding that "[p]rivatizations at arm's length and for fair market value must lead to the conclusion that the privatized producer paid for what he got and thus did not get any benefit or advantage from the prior financial contribution bestowed upon the state-owned producer." Privatization at arm's length and for fair market value may result in extinguishing the benefit. Indeed, we find that there is a rebuttable presumption that a benefit ceases to exist after such a privatization. Nevertheless, it does not necessarily do so. There is no inflexible rule requiring that investigating authorities, in future cases, automatically determine that a "benefit" derived from pre-privatization financial contributions expires following privatization at arm's length and for fair market value.

However, the Appellate Body did not reason, as we have, that the price at which a privatization of public assets takes place is irrelevant to the existence or not of a continuing benefit from a prior non-recurring subsidy. Rather, the AB argued that the market price of an asset need not reflect the "actual exchange value of the continuing benefit of past non-recurring financial contributions," because the government may be able to manipulate private market valuations by changing or threatening to change the policy environment in which the assets operate.

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